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THE POLITICS OF INFLATION

John J. Deutsch

November, 1974



Ontario Economic Council

Toronto, Ontario

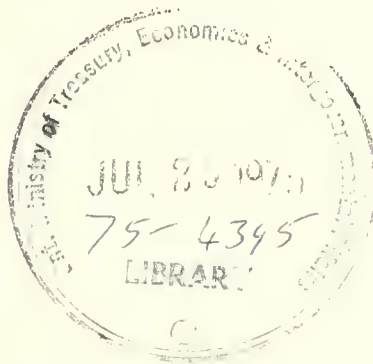
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An Address to
The Ontario Economic Council
Outlook '75 Conference
November 25, 1974
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THE POLITICS OF INFLATION

Talk by John J. Deutsch to the

Outlook 1975 Conference

Ontario Economic Council

Toronto, November 25, 1974

When your chairman, Professor Reuber, invited me to speak on the subject, "The Politics of Inflation," I was, at first, taken aback. Politics is not "my thing," and I have no special knowledge about political processes. However, when I began to think about it I became intrigued. It is true that the finding of solutions to the great problem of inflation now plaguing us has long been regarded as a matter for economic analysis and for learned experts. But it is obvious that whatever solutions may be devised they are of no use unless they are put into effect. When one looks at what economic analysis is saying and at what recognized experts are proposing, there is no great mystery about what needs to be done. Yes, there are important differences as to how it should be done and about priorities, but the real need is to get a resolution of these differences which is inherently a political problem, and to get action which is a political process.

Professor Milton Friedman has stated the matter very explicitly. He says, "The real obstacles to ending inflation are political, not technical. Ending inflation would deprive government of revenue that it now obtains without legislation. Ending inflation would also produce a temporary, though perhaps fairly protracted period of economic recession or slow-down and relatively high unemployment." Regardless of what



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we think of this, whenever we speak of government revenues and of the possibilities of unemployment, we speak of politics.

It was not always like this. In the first place, it is interesting to note that chronic and accelerating inflation in peacetime is a quite recent phenomenon. It appears to be a disease of modern social and political developments. Historically, inflation was nearly always associated with wars and revolutions. For several hundred years before World War I price levels in most of the principal Western countries remained remarkably stable, except during major social or military upheavals. For example, the real value of the British pound sterling on the eve of World War I in 1914 was about the same as it had been in 1774. However, its real value fell in half by 1941, a span of only 27 years. It fell in half again by 1967, a span of only 16 years. At the present rate of inflation in Britain the pound would fall in half again in about five years. The British experience, while somewhat more extreme at times, is not altogether untypical of that of many other Western countries.

It is clear that something important has changed. Of course, in the advanced industrial countries the changes have been many and far-reaching. However, when we examine the modern disease of inflation I think we should look particularly at the changes in the role of government in our society. Over the past half-century or so, and especially since the end of World War II, the changes in the role of government have been very profound. Prior to these quite recent periods, governments were not generally held responsible for maintaining levels of employment. That was the responsibility of the private economy. Indeed it had been widely held for a long time that the active general intervention of government

would only make matters worse. The role of government was to stay out of the economy as much as possible and to create a favourable climate of incentives for the private economy. Also, it was thought wise that governments should keep their hands off the money system in order to ensure its integrity and soundness. The supply of money and credit and hence the levels of prices and wages was to be determined by the balance of trade and the movements of capital resulting from the automatic disciplines of the gold standard as applied both to foreign exchange and to the credit system at home.

These attitudes are utterly different from those of today. Gone is the gold standard with its automatic rules. The management of the money system is now the direct responsibility of government and hence of the political decision-making process. Among the influences that brought about this change was the argument that governments should be freed from the disciplines of the gold standard and should regulate the supply of money, the conditions of credit and the foreign exchanges so as to achieve certain social and economic goals. It was argued that modern economic doctrines and the skills of modern experts would enable governments, through their central banks, to use the money system to promote economic growth and economic stability in line with our more enlightened modern aspirations. Belief in these higher possibilities carried the day nearly everywhere after World War II. Internationally the gold standard was replaced by the United States dollar standard which was managed by the government of the United States. Hence the entire world's monetary reserves and the operation of the world monetary and exchange system came under the powerful influence of the political decision-making

processes of the United States. Indeed, during the past decade, the political imperatives of the United States have had a most profound effect on the whole of the international inflationary scene.

Closely linked with these developments in the monetary scene, there was another striking departure in the role of government. After World War II, many governments, including our own, assumed direct responsibility for the maintenance of "full" employment, or what has been more euphemistically called "high" levels of employment, at all times. Again, it was argued that modern economic doctrines and skills would enable governments to achieve this socially desirable objective. The new Keynesian doctrine which had evolved out of the Great Depression had now become orthodox.

Under the Keynesian doctrine, the general level of employment is determined by aggregate demand, or what the layman calls the level of total purchasing power in the economy. The Keynesians argued that governments had the capacity to manage aggregate demand in such a way as to maintain both full employment and a high degree of economic stability. They could do this through the flexible use of two large levers, namely monetary policy and fiscal policy. However, governments must first free themselves of the shackles of the past. In the case of monetary policy, the shackles of the gold standard must be removed. In the case of fiscal policy, the shackle of the balanced budget must be dropped.

In the past, the idea of the balanced budget was used as a political and doctrinal device to impose fiscal responsibility upon easy-spending governments. It was argued that the removal of this restraint would enable governments to use government expenditures and budget deficits, along with easy money, to expand aggregate demand when needed to expand

employment; or to cut government expenditures and achieve a surplus in order to contract aggregate demand when required to restrain inflation. Under the new orthodoxy the management of aggregate demand for full employment called for budgetary flexibility and for managed money.

Governments generally accepted the new freedoms with alacrity because they were related to the desirable social goals of full employment and rising welfare, and because they were politically attractive. Consequently, throughout the postwar period the management of aggregate demand was a major preoccupation of the public authorities and of political discussion.

Looking back now upon nearly thirty years of the new Keynesian dispensation, we can state certain results which have been widely noted. The new role of government and the new use of monetary and fiscal policies have succeeded in avoiding the recurrence of major depressions and massive unemployment; and they have fostered throughout Western industrial society rapid economic growth and rising standards of living. However, they have also fostered a heritage of world-wide chronic inflation which at first caused little concern but is now jeopardizing the very social aims we were seeking and is threatening us with the worst of all possible worlds, namely the social evils of inflation along with rising unemployment. New and horrible-sounding words such as "stagflation" have been coined to describe this unexpected condition.

We must now ask what went wrong and why has the faith in the new doctrines proven to be excessive. To put it briefly, the main trouble has been that the proper management of aggregate demand has turned out to be beyond the capacity of our political processes and to a lesser

degree beyond our technical knowledge.

In order to manage aggregate demand so as to achieve full employment and economic stability, it is obviously necessary in the first instance to be able to forecast for some distance ahead the main forces operating in the economy. How else is it possible to put in place the appropriate monetary and fiscal policies? Experience has shown that our ability to make such forecasts with sufficient reliability is very limited. If we look at the official forecasts that have been used over the years for government budget-making, we find that they have been wrong or wide of the mark a distressingly large number of times. As a result, the management was frequently wrong, or was either too little or too late. In this connection there was also a particular difficulty which has proven to be critical. Forecasts which call for unpleasant and painful decisions are unwelcome and the experts making such forecasts have seldom achieved the creditability required to persuade the political authorities in such circumstances. This being the case, it is not surprising that the political management of policy involving money and government expenditures has been biased in an inflationary direction.

In the face of these short-comings, both technical and political, it was thought for a time that the problem could be solved by making frequent and short-term adjustments in policy, including several budgets during the course of a year. If forecasting is unreliable, then we would wait until the facts are clear and adjust our stance rapidly as the facts changed. This was known as "fine tuning" the economy. However, this proved to be a nonsense because monetary and fiscal policies affect the levels of economic activity only after substantial and variable time

lags. Consequently, frequent tinkering was either useless or even damaging.

The substantial time lags between adjustments in monetary and fiscal policies, and their effects on employment and price levels, has had serious political implications. For example, in times of rising inflation when monetary and fiscal restraint is called for, political pressures always develop asking for the removal of the restraints before they can take effect adequately; conversely, when unemployment persists during a recession, political pressures demand monetary and fiscal expansion when it is too late. There has been a strong tendency for the authorities to yield to these untimely pressures with the result that the inflation is never really checked and is progressively compounded.

During the early 1960s, there appeared on the scene quite a simple formula which, it was thought, would prove to be a very useful guide to the authorities for managing aggregate demand. It was pointed out that past experience has shown that the rate of unemployment is related inversely to the rate of inflation. If this were so, the authorities would be in a position to choose whichever combination of unemployment and inflation was most acceptable from among the choices indicated by experience. It was argued that if the authorities wished to achieve a smaller rate of unemployment, they could do so by means of expansionary monetary and fiscal policies and accept a predictably higher rate of inflation. Conversely, if the rate of inflation was higher than was acceptable, it could be reduced by tighter monetary and fiscal policies and by accepting a predictably higher rate of unemployment. However, this simple formula has not turned out to be a solution for those looking for a politically easy and quick answer. It has become clear that the

rate of inflation is affected not only by current conditions, but is very powerfully influenced by what the public expects inflation to be in the future. If the public, through its experience of the past, fears that there will be a high rate of inflation in the future, then we may have both high inflation and high unemployment at the same time--the condition which is developing today in much of the Western world.

When governments were asked after World War II to ensure full employment at all times, it was argued that the new economic doctrines would enable the authorities to manage government budgets and money in such a way as to virtually do away with recessions and business cycles. We have learned from experience that these doctrines of management can be, and are, used for political purposes as well as for dealing with recessions.

The much observed "stop-go" policies in Great Britain have been closely associated with the political time-tables of elections. Perhaps the most famous and most tragic example of the political imperative is the course of events in the United States after the escalation of the Vietnamese war in 1965. For political reasons it was decided to go forward with both the expanded war and the Great Society programmes without raising taxes. The consequent inflationary pressures operated not only in the United States, but resulted in the massive outflow of United States dollars and the rapid expansion of monetary reserves in the rest of the world. This explosion of monetary reserves became the fuel for world-wide inflation. Later, the abandonment of the anti-inflationary monetary and fiscal policies in the United States during 1971 and 1972 was not unrelated to the political events of that period. In Canada,

the very rapid monetary expansion and the high rate of increase in federal government expenditures during the period 1972 to 1973 also was not unrelated to the political events of that period. I think we can say that we now have political cycles as well as business cycles. This is the new reality that has come out of the great increase in the management role of governments.

This management role of governments was relatively easy during the years immediately following World War II. During those years there was wide-spread fear of a return of a great depression. Consequently governments were advised by the experts and by many others to be expansionary. That meant rising expenditures, easy money and new programmes, everything that was pleasant and politically appealing. As you know, during this period monetary policy was completely accommodating, interest rates were fixed at very low levels, and the role of government in society expanded rapidly.

However, when the time came to exercise the other side of the new management role, namely to apply restraint in order to avoid inflation, the trouble began. Restraint could mean higher taxes, tight money, high interest rates, more severe limits on government expenditures, austerity and probably more unemployment. None of these things are pleasant or politically appealing. In these circumstances there is always the tendency to look quickly for someone to blame such as the trade unions with their wage demands, the profiteers, the speculators, the big corporations, the foreigners, the oil sheiks, the Peruvian anchovies, or whatever else can be found at a particular time in that great and wonderful museum of political scape-goats. It is true that any one of these can aggravate the situation and make the solution more difficult, but none can be the

real cause of the problem. Inflation by its very nature is a monetary phenomenon. After all, we are speaking about prices and costs expressed in terms of money. Inflation cannot be brought under control without the pursuit of appropriate monetary and fiscal policies whatever else may be done by way of amelioration or supplementation. This lesson has been thoroughly learned even in the most authoritarian countries where controls and central direction can be used with universal effect. During my visit to China this past summer, I was amazed to find that there was no inflation, no line-ups, no significant rationing, no black markets. Since it is still a poor country I asked my official hosts, "How is this possible?" They replied that they did not believe in the nonsense of inflating the money system.

Of course, the problem of management on the restraint side is a very difficult one for government. Today, the role of government in all our activities has become so massive that government is constantly confronted, as I have said elsewhere, with the conflicting pressures of every interest group in the society and by the urgent pleas of every worthy pursuit in the cause of social betterment. Government everywhere has the greatest difficulty in reconciling these mounting pressures and demands with the means at hand. The pressures and demands always add up to much more than the real resources available at the time. As the two must be brought into balance, governments have too frequently sought to cope with their predicament by avoiding the hard decisions involved and by resorting to the inflation of the money system instead. By this method the balance between the pressures and the available resources is achieved by taking away resources from those who are unable or too

weak to protect themselves from the falling value of money and transferring the resources to those who are strong or fortunate.

I am not trying to suggest that Mr. Trudeau, for example, has a printing press in the basement of his home at 24 Sussex Street in Ottawa which he uses to print more money whenever he is unable to reconcile conflicting demands. No, the process is much more indirect and much more subtle. I think it was put very nicely this summer in the cautious language of a great central banker when Mr. Hays, the President of the Federal Reserve Bank of New York, told a Congressional Committee, "...preventing credit from expanding to accommodate a Federal deficit would tend to put immediate upward pressures on interest rates. Such developments are, of course, unpopular and it is all too easy, almost without realizing it, to accommodate the pressures generated by fiscal deficits [through credit expansion]."

As I have already said, the reconciliation of conflicting pressures when restraint is called for to control inflation involves only painful and unpleasant choices for the political authorities. They can choose between such courses of action as a sharp reduction in aggregate demand with substantial unemployment over a relatively short period; or a more moderate reduction in aggregate demand with smaller unemployment and slow growth over a prolonged period; or a moderate reduction in aggregate demand and price and wage controls, with less immediate unemployment but with more bureaucratic intervention and increasing inequities and inefficiencies; or by managing aggregate demand so as to ride along with the world outside in the hope that our chief trading partners will bring matters under control; or by accepting inflation and making an effort to remove the resulting

inequities through indexing most if not all money payments and money obligations. These are some of the various possibilities and there may be others. Everyone of these involves choices between priorities, between different social values, between different distributions of benefits and costs, and between different long-run goals.

A short time ago, Prime Minister Harold Wilson said on the BBC, "There are differences between parties, but nothing like so wide as the differences between all the economists and the experts and the commentators, who are giving us totally different prescriptions for what should be done." The reason for all this diverse and often conflicting advice is that the choices for action have to do fundamentally with choices between differing priorities, social values, and goals. Here neither the economist, the expert, nor the commentator can have any unique claim to the answer. The resolution of the diversity of attitudes regarding priorities, values and goals is precisely the task of politics in a democratic society.

Kenneth Galbraith said recently that, "The political choice is wonderfully clear. It is between painful action in the short-run and political extinction in the somewhat longer-run. Most politicians will avoid the immediate pain--hoping that Providence will intervene to save them from their eventual fate." I am sure that all of us hope sincerely that our political institutions will prove to be capable of responding more effectively than Professor Galbraith has feared.

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